

Good morning,

Back to basics, Monday was a day of profit taking in equities, with the typical reallocation back to Treasuries and Agency debt (although Agencies did not rally as much) and the classic demand for USD, as liquidity is repatriated. The S&P500 lost 2.2%, (909pts); gold fell to \$913/oz and crude oil to \$58.12/bl. The Fed pumped another \$3.51BN, when it bought Treasuries. The purchase represented 33.7% of the offered amount, concentrated in the 2026/27 maturities. For the first time in weeks, volume was low at \$120Bn (89.6% of 30-moving avg.).

No economic data was released yesterday. In credit, spreads widened across all sectors. The CDX IG12 closed at 149bps. The rush to issue remained intact, with 13 borrowers accessing the market. Anheuser-Busch sold \$1.55BN 5-yr 5.37%, \$1BN 10-yr 6.875% and \$450MM 30-yr 8%. Microsoft issued \$2BN 5-yr 2.95%, \$1BN 10-yr 4.2% and \$750MM 30-yr 5.2%. But we also had Becton, Dickinson & Co. (\$750MM 2019/2039), San Diego Gas & Electric Co. (\$300MM 30-yr), SandRidge Energy (\$365.5MM 5-yr) and Southern Co. (\$350MM 5-yr). Even Simon Property Group (a U.S. mall owner) issued \$600MM of 2014s, which may yield 7%.

One market that I may have neglected but not forgotten is that of Municipal debt. Very relevant parts of the total US fiscal expenses are generated at lower than federal levels. Interestingly enough, while the federal government runs the wildest financial gap ever known to mankind, municipal and state governments are taking action to reduce their deficits. A new product, the BABs (Build America Bonds) has been launched. These taxable munis, like everything else are enjoying a rally. Even at tighter spreads, the municipal market is however lagging last year in issuance, with \$128BN vs. \$149BN year-to-date. But at least, the fact that municipalities and states are trying to close the financial gap is good news. Nevertheless, on Friday, US Treasury Secretary Geithner said that he is evaluating assistance for the municipal bond market.

Last but not least, at the close of yesterday's session Ford Motor Company registered a 300MM shares public offering of its common stock (par value of 1 cent), with a grant to the underwriters of a 30-day option to purchase another 45 million shares.

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Back to my point from yesterday, I perceive a serious division of opinions on the future. Some analysts are very positive, recommending a long-credit position. Others (mainstream economists) have trouble explaining why we see the combination of a weaker USD, a steepening yield curve, rising commodity prices with low inflation and negative growth. There are even those who actually see a very positive outlook in a steeper yield curve. Finally, there are those who are certain the Fed will size up its deficit monetization program and see grave danger coming from this.

From our Thesis No. 1, I can see consistency in a weaker USD, a steeper yield curve and rising commodity prices. Thesis No. 1 stated that: "When the Fed injects liquidity, asset prices rise. When the Fed does not inject liquidity, asset prices fall". This is another way of saying that as long as the Fed and all the other central banks keep flooding liquidity and feeding us with announcements, we can see prices NOT falling... **But asset prices have begun to fall. Or is this just profit taking?** Honestly, I don't see a fundamental trend here. I think we need to see more buying and more announcements from the Fed.

The inconsistencies that most analysts see are based on the belief that inflation is not here yet. In their paradigms, the increase in asset prices (that leads to refinancing and will later lead to capital expenditures) is not related with an increase in the Consumer Price Index (**this error is the same that leads to believe that inflation brings growth**). The denial is so extreme that for instance, Morgan Stanley's Interest Rate Strategy team in its May 8 report (page 4) suggests that it's inflation expectations that drive the steepening in yield curves, as opposed to "realized" inflation. Thus, if the market did not expect inflation, long-term yields would not rise! Inflation expectations and realized inflation are different things... I can only disagree with this notion. **Nobody needs to expect anything. It is a universal law that that which is free is wasted. If the Fed buys 1/3 of the deficit creating free money, that free money will be wasted. If I give money to my 3-year old, he will buy candy. If I give bread and almonds to a starving squirrel, the squirrel will eat the almonds and leave the bread. Finally, if I give \$300bn in Treasuries purchases to investors, they will sell the Treasuries and USD and buy stocks with horrible earnings, oil that is oversupplied, gold that is underdemanded and bonds that may be close to default. It would be inconsistent and irrational if it wasn't so!!!**

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After a few weeks, Thesis no. 3, proposed on April 27<sup>th</sup>, may have merit now: "Knowledge of an exit plan is a condition for the stocks AND credit markets NOT to fall". A bit of this was seen yesterday, when Bloomberg quoted at 7:40am Mr. Trichet (European Central Bank) saying that central banks are determined on an exit strategy and denying rumors of discussions on foreign exchange issues, with other central banks.